FILE COPY

Office - Supreme Court, U. S.
FILED
DEC 12 1939
CHARLES ELMORE CROPLEY
CLERK

No. [redacted] 8

IN THE

Supreme Court of the United States

October Term, 1939.

CRANE-JOHNSON COMPANY, a corporation of North Dakota,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

JOHN E. HUGHES,
First National Bank Bldg.,
Chicago, Illinois,
Counsel for Petitioner.

U. S. Law Printing Company, 2817 N. Halsted St., Chicago, Ill.

INDEX.

Page

Petition for writ of certiorari to the Circuit Court of Appeals for the Eighth Circuit:

- Opinions Below 2
- Jurisdiction 2
- Questions Presented 2
- Statutes and Regulations Involved 3
- Statement 4
- Specification of Errors to Be Urged 8
- Reasons for Granting the Writ 8

Brief in Support of Petition 12

- Opinions Below 12
- Jurisdiction 12
- Questions presented, statutes and regulations involved 12
- Specification of errors to be urged 12
- Point I. The charter of a corporation is a written contract executed by the corporation 12
- Point II. The provisions of the general corporation law of North Dakota which are written and expressly deal with the payment of dividends, are as much a part of said charter contract as if they were set forth therein 14
- Point III. The stock certificate of the corporation constitutes a written contract executed by it under its seal 15

Point IV. The written provisions of the state law expressly dealing with the payment of dividends are as much a part of the stock certificate as if they were set forth verbatim therein..... 16

Point V. Petitioner's charter contract expressly forbade it to declare a dividend in 1936..... 18

Point VI. Imposition of the surtax on income which is not distributable violates both the taxing statute and the Fifth Amendment..... 19

Point VII. The decision below discriminates against the petitioner in favor of others similarly situated in violation of the Fifth Amendment..... 20

Point VIII. The legislative history and intent and spirit of the statute support petitioner..... 22

CITATIONS.

Cases:

Ainsworth v. Southwestern Drug Co., 95 F. (2d) 172, 173 (C. C. A. 5)..... 14

Chenango Bridge Co. v. Binghampton Bridge Co., 70 U. S. 51, 53..... 12

Cochran v. Commissioner, 78 F. (2d) 176, 179 (C. C. A. 4)..... 17

Culbertson's, In re, 54 F. (2d) 753, 757 (C. C. A. 9) 15

Dartmouth College v. Woodward (1819), 4 Wheaton 518 (17 U. S. 418), 682-683..... 12

Edwards v. Douglas, 269 U. S. 204, 214..... 19

Hadden v. Commissioner, 49 F. (2d) 709 (C. C. A. 2) 24

Hanson's Estate, In re, 159 N. W. 399, 38 So. Dak. 1 14

Hassett v. Welch, 303 U. S. 303, 314 16

Home Building & Loan Assn. v. Blaisdell, 290 U. S. 398, 429, 430 ..... 12, 14

Helvering v. Bliss, 293 U. S. 144, 151 17

Helvering v. Canfield, 291 U. S. 163, 166 18-19

Jones v. Mo. Edison Elec. Co., 144 Fed. 765, 770 .. 15

Johnston, In re, 33 B. T. A. 551, 553 17

Kelly Springfield Tire Co. v. United States, 81 F. (2d) 533, 535 17

Lynch v. United States, 292 U. S. 571, 577 14

Old Colony Trust Company v. Commissioner, 301 U. S. 379, 383 17

Personal Industrial Bankers v. Citizens Budget Co., 80 F. (2d) 327, 328 (C. C. A. 6) 12

Roche's Beach, Inc. v. Commissioner, 96 F. (2d) 776, 779 (C. C. A. 2) 17

Sanford v. Commissioner, 106 F. (2d) 882, 884 24

Ulness v. Dunnell, 61 N. D. 95; 237 N. W. 208 18

United States v. Jim Fuey Moy, 241 U. S. 394, 401 22

United States v. Merchants National Trust & Savings Bank, 101 F. (2d) 399, 404 (C. C. A. 9) 17

United States v. Quincy, 4 Wallace 535 14

Willcuts v. Milton Dairy Co., 275 U. S. 215, 218 .. 19

Yoakam v. Providence Biltmore Hotel Co., 34 F. (2d) 533, 541 15

TEXT BOOKS AND REFERENCES.

36 Columbia Law Review, p. 1343 ..... 13, 15

Cook on Corporations (8th Ed.), Secs. 492-494 12

Corporations, 14 C. J., Sec. 162, page 161 12

Congressional Record, Vol. 80, Part 8, p. 9058 ..... 22, 23

Vol. 1, Fletcher's Encyclopedia on Corporations, p. 440, Sec. 226 14

50 Harvard Law Review, 322, 341 15

House Report No. 2475, 74th Cong., 2nd Sess. 24

Indiana Law Journal 19, p. 28 13

XII Indiana Law Review 19, 28 7

I. T. 3152, C. B. 1938-1, p. 155 16

Law of Federal Income Taxation, Paul & Mertens, Vol. III Supplement, Sec. 32 A43 13

Senate Hearings, pp. 265-268 24

Senate Report 2156, 74th Cong., 2nd Sess., pp. 12, 13, 15 17

North Dakota Compiled Laws—Supplement—(Ann.) 1913-1925 3

Revenue Act of 1936 (U. S. C. Supp. III, Title 26, Sec. 13a):

Sec. 14 (a) (2), (b) 3

Sec. 26 (c) (1) 4, 5, 21

Sec. 27 (h) 20

Treasury Regulations 94 (1936 Ed.) 4

IN THE

Supreme Court of the United States

October Term, 1939.

CRANE-JOHNSON COMPANY, a corporation of North Dakota,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

The Crane-Johnson Company, a corporation of North Dakota, by John E. Hughes, its attorney, prays that a Writ of *Certiorari* issue to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit entered in the above-entitled cause on August 8, 1939, affirming a decision of the United States Board of Tax Appeals.

OPINIONS BELOW.

The opinion of the Board of Tax Appeals is published in *38 B. T. A. 1355.* The opinion of the Circuit Court of Appeals is published in *105 F. (2d) 740.*

JURISDICTION.

The judgment below was entered August 8, 1939, and a Petition for Rehearing was denied September 15, 1939 (R. 46). The jurisdiction of this Court is invoked under *Section 240 (a) of the Judicial Code* as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED.

Whether, for the purpose of the credit permitted in the determination of the surtax on undistributed profits under the Revenue Act of 1936, the taxpayer's charter constitutes "a written contract executed by the corporation, which contract expressly deals with the payment of dividends"? If not, whether the taxpayer's stock certificates constitute a written contract executed by the corporation which contract expressly deals with the payment of dividends?

Is the law, as construed by the Court below, so arbitrary and capricious that it violates the *Fifth Amendment,* in classifying the petitioner with others not similarly situated and in discriminating against the petitioner in favor of others who are similarly situated?

To put the question more concretely, the taxpayer's income for 1936 was $13,450.76. It had a capital deficit of $21,251.40. Under North Dakota statutes it could declare dividends only from "surplus profits". There was no surplus but instead an impairment of capital stock. Since it was expressly prohibited by North Dakota statute from distributing any dividend and since the statute constituted

a part of its charter and since the charter was a written contract with the State and its stockholders, taxpayer contends that it was prohibited by the provisions of a written contract expressly dealing with the payment of dividends, from declaring any dividend during the taxable year and hence is literally within the words of the Revenue Law allowing a credit against the undistributed profits tax. The same is true of taxpayer's stock certificate.

STATUTES AND REGULATIONS INVOLVED.

North Dakota Compiled Laws—Supplement—(Annotated), 1913-1925:

"*Sec. 4543. Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock.***"

REVENUE ACT OF 1936

(U. S. C. Supp. III, Title 26, Sec. 13a):

"*Sec. 14.* Surtax on Undistributed Profits.

(a) *Definitions.*—As used in this title—

* * *

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in *section 27* and the credit provided in *section 26 (c)*, relating to contracts restricting dividends.

(b) *Imposition of Tax.*— There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in *subsection (c):*

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

* * *"

"*Sec. 26.* Credits Of Corporations. In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * *

(c) *Contracts Restricting Payment of Dividends.*—(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

Treasury Regulations 94 (1936 Ed.), promulgated under the Revenue Act of 1936.

"The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of *26 (c).*"

STATEMENT.

The facts in this case were stipulated (R. 12) and the Board found the facts as stipulated (R. 14). It was stipulated that petitioner was incorporated under the statutes of North Dakota, April 29, 1903. That as of January 1, 1936, petitioner had a deficit of at least $21,251.40. There was a surplus in March 1930 (R. 12).[1]

Petitioner's net income from the taxable year was $13,450.76 (R. 12-13). Its adjusted net income was $12,032.72 (R. 13, 14). The Statute of North Dakota expressly forbade its directors to declare any dividend. In its return for 1936 it claimed a credit under *Section 26*

1. It was stipulated that the records prior to January 1, 1929 are not susceptible of analysis to show how the deficit occurred but since there was no deficit in March 1930 and the deficit occurred subsequent to that date, it is immaterial whether the records prior to the time there was a surplus are susceptible of analysis.

(c) (1) of the Revenue Act of 1936 in the computation of the surtax on undistributed profits. The Commissioner disallowed this credit, determined a surtax of $1771.36 on undistributed profits, and asserted a deficiency in that amount (R. 12, 13). The Board of Tax Appeals approved the action of the Commissioner (R. 21-22) and this action was affirmed by the Circuit Court of Appeals (R. 41).

In addition to the other income taxes (a normal tax of from 8 to 15% and an excess profits tax from 6 to 12%) Congress by the Revenue Act of 1936 imposed a special undistributed profits surtax of from 7 to 27% on the portion of earnings which corporations did not distribute as dividends to their stockholders.

It was recognized that in certain cases corporations could not distribute dividends and in such cases a credit was allowed. The provision allowing the credit and which the petitioner claims is applicable in this case is the provision of *26 (c) (1) of the Revenue Act of 1936* allowing a credit in the following language:

> "An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

In the case at bar petitioner's adjusted net income was $12,032.17 and since its capital impairment was $21,251.41 there was no excess of adjusted net income which could be distributed as dividends without violating its charter contract and hence we contend its case falls literally within the above quoted statute and it is entitled to the credit thereby allowed.

It was conceded below and must be conceded here that if petitioner's charter constitutes a written contract executed by petitioner containing a provision which expressly deals with the payment of dividends, then the decision of the Court below was wrong and petitioner is entitled to the credit. The same is true if its stock certificate constituted such a contract.

Since petitioner's charter was executed prior to May 1, 1936, the first question in this case is whether it is "a written contract executed by the corporation prior to May 1, 1936" and if so whether it contains a provision which "expressly deals with the payment of dividends".

Petitioner claims that its charter is a written contract between its stockholders, itself and the State, that this charter consists among other things of the express provisions of the State Corporation Law as fully as if it were repeated *verbatim* therein and that the provision of this State Law which the charter contract contains "expressly deals with the payment of dividends". Hence petitioner is entitled to the credit allowed by the above provision of the Revenue Act and is literally within it. * * * Moreover, to deny such credit in this case is to discriminate against the petitioner in favor of other taxpayers which are subject to restrictive contracts and therefore similarly situated with respect to the payment of dividends, in violation of the *Fifth Amendment.*

Petitioner further claims that the surtax on undistributed profits is framed upon the premise that the income to be taxed shall be distributable by the taxpayer corporation, and that it is a violation not only of the taxing law but of the *Fifth Amendment* to impose the surtax on its income which was not distributable.

The regulation promulgated under the 1936 Revenue Act expressly declared that a charter would not be considered a written contract within the above-quoted provision of the law. This regulation, however, has not been approved by the re-enactment of the Statute because the short experience under the undistributed profits tax proved it a failure and it was not re-enacted. Shortly after its promulgation the regulation was questioned by disinterested academic sources. *XII Indiana Law Review 19, 28; 36 Columbia Law Rev. 1343.*

The Board of Tax Appeals held in this case that irrespective of whether the charter was a contract expressly dealing with the payment of dividends, Congress did not intend to embrace it within this provision of the law, because the Revenue Act of 1936, as it passed the House, contained a provision giving relief to ALL deficit corporations and this provision was omitted from the conference draft that became law. However there is nothing in the legislative history showing why it was omitted. Petitioner argued in the Circuit Court of Appeals that this holding was erroneous for the reason that if legislative history could be considered, the provision contained in the House Bill granted relief to ALL deficit corporations, including those existing in States where they might legally declare dividends and the Senate considered this too broad and therefore struck it out, evidently considering that corporations restricted by charter or other contracts from declaring dividends, alone should have relief. (See page 23 annexed brief.) The Circuit Court of Appeals affirmed but on entirely different grounds than that upon which the Board put its decision (R. 41).

The Court held that the North Dakota Statute quoted on page 3 hereof made it the obligation of the Directors and not of the corporation not to declare dividends (R.

43) and that "the corporation itself has made no written contract affecting its right to declare dividends".[2] The opinion seems to hold that the charter is a written contract and again that it is not a written contract (R. 43). Again the Court seems to say that merely because a penalty is imposed on the directors the obligation is theirs alone and not that of the corporation.

The Court did not pass on the contention that the stock certificate was such a contract, although this contention was urged by petitioner. The Court also stated that if there was such contract it was implied, overlooking that the contract upon which we rely is all in writing.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

(1) In failing to hold that petitioner was prohibited from distributing any of its 1936 earnings as dividends because of the provision of the written contract executed by it prior to May 1, 1936, which provision expressly deals with the payment of dividends.

(2) In affirming the order of the Board of Tax Appeals.

(3) In failing to hold that the statute as construed by it was so arbitrary and unreasonable that it violated the *Fifth Amendment.*

REASONS FOR GRANTING THE WRIT.

The question presented by the present case is an important question of federal income tax law and one of wide general importance, not heretofore determined by

2. In another part of its opinion the Court said (R. 42): "The Supreme Court of North Dakota has held that a dividend cannot be rightfully declared by a corporation except out of the profits earned by it and that this principle is embodied in the North Dakota Statutes above referred to. **Ulness v. Dunnell, 237 N. W. 208.**"

this Court and which should be determined by this Court. The question affects all corporations in the United States which had an impairment of capital stock in 1936 and which made any profit in that year. Scores of cases involving this question from all over the country are pending in the Treasury Department before the Board of Tax Appeals and some in the Federal District Courts. It is impossible for there to be a conflict between the United States Circuit Courts of Appeal at this time because this is the first and only case decided by a Circuit Court of Appeals which involves this question. Other taxpayers similarly situated are unwilling to accept the decision of the Court below as sound law and have expressed an intention to continue to litigate their cases and are continuing to litigate them and unless the question is settled by this Court now, great expense will be imposed upon the Government and taxpayers in future litigation involving this question, other petitions for *certiorari* presenting it will be filed and in all probability its settlement by this Court will be merely postponed.

Furthermore, it is submitted the Court below has decided the very important question presented in an untenable way, because it is elementary law that the charter of the corporation is a written contract embracing among its terms the provisions of the State Statutes and the Statutes of North Dakota, as construed by the Supreme Court of the State, expressly prohibited the petitioner declaring dividends. Thus by provision in writing expressly dealing with the payment of dividends, which was a part of its charter, petitioner was restrained from paying the same. The same is true of petitioner's stock certificates.

The decision is further untenable because it gives no consideration to the underlying purpose, reason and intent of the statute and fails to attempt to reconcile this underlying intent with the construction which it gives the statute. The construction of the Court below imputes to Congress an intent to make an indefensible discrimination by allowing rich corporations to avoid the tax, while affording no escape to those in failing circumstances—and this for no reason whatever.[3]

Furthermore, it is submitted the construction adopted by the Court below results in violation of the *Fifth Amendment.* The law by its terms necessarily purports to levy a surtax on income which can be distributed by the taxpayer corporation to its stockholders. Under the construction adopted by the Court below, however, this characteristic of the tax is ignored and no distinction made between distributable and undistributable income, although this taxpayer and numerous other corporations similarly situated could not in fact or in law treat their earnings, if distributed, as income distributable to their stockholders by way of taxable dividends, but only as return of capital. The petitioner is therefore arbitrarily classified with corporations which can distribute their income and are therefore in a materially different situation.

Moreover, the interpretation adopted by the Circuit Court of Appeals permits a rich and prosperous corporation to escape the surtax, provided it happens to have executed a contract restricting payment of dividends, while it does not permit corporations with an impairment of capital stock and on the verge of bankruptcy to escape the tax, notwithstanding they are equally disabled from

3. Compare **Foley Securities Co. v. Commissioner, 106 F. (2d) 731, 735**

distributing their earnings, thus clearly and needlessly resulting in a most arbitrary and unfair discrimination between taxpayers subject to substantially the same disability.

The reasons why the important decision below is untenable are briefly developed in the annexed brief.

Wherefore it is respectfully submitted that this Petition should be granted.

JOHN E. HUGHES,
First National Bank Bldg.,
Chicago, Illinois,
Attorney for Petitioner.

BRIEF IN SUPPORT OF PETITION.

A statement of the jurisdiction of this Court, a statement of the case and the assignment of errors are set forth in the foregoing petition and not repeated here. It is submitted that the following points, all of which are elementary and undisputed law, clearly sustain the petitioner's case.

POINT I.

THE CHARTER OF A CORPORATION IS A WRITTEN CONTRACT EXECUTED BY THE CORPORATION.

Among the multitude of authorities so holding see, *Dartmouth College v. Woodward (1819), 4 Wheaton 518 (17 U. S. 418), 682-683; Home Building & Loan Assn. v. Blaisdell, 290 U. S. 398, 429, 430; Corporations, 14 C. J., Sec. 162, page 161; 7 Ruling Case Law, Sec. 71, p. 93; Cook on Corporations (8th Edition), Secs. 492-494; Personal Industrial Bankers v. Citizens Budget Co., 80 F. (2d) 327, 328 (C. C. A. 6th).*

Between the decision in the *Dartmouth College case* and the decision in the *Home Building & Loan Assn. case*, numerous decisions of this Court have repeated the doctrine. In *Chenango Bridge Co. v. Binghampton Bridge Co., 70 U. S. 51*, at page *73*, the Court said:

> "We have supposed, if anything was settled by an unbroken course of decisions in the federal and state courts, it was, that an Act of incorporation was a contract between the State and the stockholders. All courts at this day are estopped from questioning the doctrine. The security of property rests upon it, and every successful enterprise is undertaken, in the unshaken belief that it will never be forsaken.
>
> "A departure from it now would involve dangers to society that cannot be foreseen, would shock the sense of justice of the country, unhinge its business inter-

> ess, and weaken, if not destroy, that respect which has always been felt for the Judicial Department of the Government. An attempt even to reaffirm it, could only tend to lessen its force and obligation."

We do not multiply citations but all text books and innumerable decisions of lower federal Courts and of all state Courts have uniformly repeated as elementary law the rule for which we contend. It is a fixed legal principle which was well known to members of Congress.

In the article on the *Undistributed Profits Tax* in *XII Indiana Law Journal 19, at p. 28, apropos* of the section of the income tax law involved here, it is said:

> "That the charter of a corporation is a contract was determined long ago in the famous *Dartmouth College case,* and the charter in the case of the Indiana corporation contains provisions which 'expressly deal with the payment of dividends.' This would seem a sufficient compliance with the requirements of *Subsection 26 (c) (1)* of the Act to entitle the corporation to credit when it is prevented from paying dividends by the terms of its charter."

In the article in *36 Columbia Law Review, page 1343,* it is said:

> "The Treasury has excluded corporate charters from the category of contracts thereby repudiating the traditional definition of a charter as a contract between state and corporations".

Also the charter is a contract executed by the corporation. See the collection of authorities in the *Law of Federal Income Taxation, Paul & Mertens, Vol. III Supplement, Sec. 32:A43.*[4]

---

4. One thing the Legislative History of the Act conclusively shows is that Congress attached no special importance to the word "executed". The Ways and Means Committee referred to a "written contract in existence prior to March 3, 1936". (See Ways and Means Committee Report 2475, 74th Congress, 2nd Session, page 8.) (Boldface ours.) The Senate Finance Committee referred to contracts "entered into prior to March 3, 1936". (Finance Committee Report No. 2156, 74th Congress, 2nd Session, p. 12.) (Boldface ours.) For a definition of the word "executed", see 28 C. J. p. 278. Both the charter and the stock certificates are executed contracts within the meaning of this definition.

POINT II.

THE PROVISIONS OF THE GENERAL CORPORATION LAW OF NORTH DAKOTA WHICH ARE WRITTEN AND EXPRESSLY DEAL WITH THE PAYMENT OF DIVIDENDS, ARE AS MUCH A PART OF SAID CHARTER CONTRACT AS IF THEY WERE SET FORTH THEREIN.

Among the many authorities so holding, see, *Ainsworth v. Southwestern Drug Co., 95 F. (2d) 172, 173 (C. C. A. 5th); Vol. 1, Fletcher's Encyclopedia on Corporations, p. 440, Sec. 226; Home Building & Loan Assn. v. Blaisdell, 290 U. S. 398, 429, 430; In re Hanson's Estate, 159 N. W. 399, 38 So. Dak. 1.*

In *United States v. Quincy, 4 Wallace 535,* the Court said:

> "It is also settled that the laws which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as if they were expressly referred to or incorporated in its terms. This principle embraces alike those which affect its validity, construction, discharge and enforcement."

Recently in *Lynch v. United States, 292 U. S. 571,* construing a war risk insurance policy, this Court said at page *577:*

> "The terms of these contracts are to be found in part in the policy and in part in the statutes under which they are issued and the regulations promulgated thereunder".

POINT III.

THE STOCK CERTIFICATE OF THE CORPORATION CONSTITUTES A WRITTEN CONTRACT EXECUTED BY IT UNDER ITS SEAL.

In re Culbertson's, 54 F. (2d) 753, 757, (C. C. A. 9); Jones v. Mo. Edison Elec. Co., 144 Fed. 765, 770; Yoakam v. Providence Biltmore Hotel Co., 34 F. (2d) 533, 541; 36 Columbia Law Review, p. 1343.

In *36 Columbia Law Review, page 1343,* where the provision of the law here involved and the regulation is discussed, it is said that the stock certificate satisfies the provisions of the law with reference to a written contract executed by the corporation.[5] See also *50 Harvard Law Review 322,* at page *341.*

It was recognized in the debates in Congress that a stock certificate constituted a written contract within the provisions of the statute involved in this case, as the colloquy between Mr. Vinson, who was in charge of the Bill in the House and another Member shows.[6]

---

5. "But even if it be assumed that there can be no contract with a non-existent entity, an objection which may be met by the theory of novation, the stock certificate which incorporates the terms of the charter, may realistically be viewed as a contract between corporation and shareholder, and therefore within the contemplation of the unqualified statutory term 'contract'." **36 Columbia Law Review 1343.**

6. **80 Congressional Record, part 6, p. 6230,** shows the following:

"Mr. Hollister: 'I am not discussing the debt situation. Let us assume this condition comes into effect with respect to a preferred stock issue * * *. Let us suppose in the preferred stock issue it is provided that in the event dividends are declared of more than a certain amount then certain voting rights will come into effect or certain things will have to happen. Has that been covered in any way?'

Mr. Vinson of Kentucky: 'It seems to me that certainly comes under paragraph 14, the contract provision.'

Mr. Hollister: 'That is not a contract.'

Mr. Vinson: 'Certainly it is a contract.'"

POINT IV.

THE WRITTEN PROVISIONS OF THE STATE LAW EXPRESSLY DEALING WITH THE PAYMENT OF DIVIDENDS ARE AS MUCH A PART OF THE STOCK CERTIFICATE AS IF THEY WERE SET FORTH VERBATIM THEREIN.

The Bureau of Internal Revenue has ruled that where provisions are set forth *verbatim* in a stock certificate restricting the payment of dividends they are within the provisions of the law involved herein and the taxpayers are entitled to a credit *I. T. 3152, C. B. 1938-1, p. 155.* It would be a superfluous and meaningless act to repeat the provisions of a State law in a stock certificate because they are as fully part of it as if they were repeated. The provision of the Revenue Act involved here (see page 4) merely requires the provision of the contract to be written and to "expressly deals with the payment of dividends". This the provision of the State law does. The Revenue Act does not require the provision to be expressed in the stock certificate but only to "expressly deal with the payment of dividends". The word "expressly" modifies the word "deals" and not the word "provision". The provision was required to be express to prevent argument that merely contracting a debt payable during the taxable year required by implication the use of earnings for its payment and not for dividends and to avoid provisions for sinking funds in bond indentures which said nothing about dividends. Not only is the rule that doubts must be resolved in favor of the taxpayer applicable here *(Hassett v. Welch, 303 U. S. 303, 314)*, but it is submitted that Congress could have had no such insubstantial and meaningless distinction in mind in enacting the Revenue Law, that corporations which repeated the words of the law re-

stricting dividends in the certificate or in their articles of incorporation should have relief while those who did not do this meaningless act should not. A law so providing would be senseless. This Court has said that "substance and not form" governs in construing revenue laws and "taxation is eminently practical". The intent, spirit and purpose of the law must be sought. The intent was plainly and reasonably to give relief to corporations which were forbidden to pay dividends. In other words, the law allowed the corporation an option to distribute earnings and not be taxed or not to distribute and be taxed. If a corporation could not take advantage of this option even if it wanted to, justice dictated relief and not a grossly unfair and discriminatory penalty. The Court below erred in declaring the provision was an exemption which should be construed strictly. It was declared in the Committee Reports and in Congress to be a relief provision. *(Senate Report 2156, 74th Congress, 2nd Sess., pp. 12, 13, 15.)* The rule of construction is that relief provisions should be construed liberally to effectuate their purpose. *Old Colony Trust Company v. Commissioner, 301 U. S. 379, 383; Helvering v. Bliss, 293 U. S. 144, 151; Cochran v. Commissioner, 78 F. (2d) 176, 179 (C. C. A. 4); In re Johnston, 33 B. T. A. 551, 553.* In *Kelly Springfield Tire Co. v. United States, 81 F. (2d) 533, 535 (C. C. A. 3)*, the Court quoted with approval the following statement of the Court of Claims:

> "When a privilege or concession is granted, as in this statute, it is the duty of the court to give the largest and broadest construction in favor of the concession, which the language used will allow in order to afford the relief which the context indicates was intended."

Even if we assume the provision is in the nature of an exemption, still it should not be strictly construed against the taxpayer because it was granted for motives of public policy and to harmonize with State law prohibiting dividends. In such case its construction should be liberal. Compare *U. S. v. Merchants National Trust & Savings Bank, 101 F. (2d) 399, 404 (C. C. A. 9); Roche's Beach Inc., v. Commissioner, 96 F. (2d) 776, 779 (C. C. A. 2); Helvering v. Bliss, 293 U. S. 144, 151.*

POINT V.

PETITIONER'S CHARTER CONTRACT EXPRESSLY FORBADE IT TO DECLARE A DIVIDEND IN 1936.

The statute of North Dakota declared:

> "The directors of corporations must not make dividends except from the surplus profits derived from the business thereof nor must they divide, withdraw, nor pay to the stockholders or any of them, any part of the capital stock."

Under the statute no dividends might have been declared in the case at bar in the year 1936 because after the earnings for that year there was still a deficit. *Ulness v. Dunnell, 61 N. D. 95; 237 N. W. 208.*[7]

This Court has said that surplus is what remains after deducting all liabilities, including the capital stock. *Hel-*

7. In **Ulness v. Dunnell, 61 N. D. 95,** at pages **99, 100,** the Court said: "It is a well-settled principle that a dividend cannot rightfully be declared by a corporation except out of the profits earned by it: **6 Fletcher, Cyc. Corp., pp. 6209, et seq.; Fricke v. Angemeier, 53 Ind. App. 140; 101 N. E. 321.** In this state the principle is embodied in statute." * * * As noted by the Circuit Court of Appeals in its opinion, the prohibition of the statute itself rests upon the directors. It is, however, apparent from the foregoing language that the Supreme Court of North Dakota has construed the North Dakota statute as binding the corporation, which appears in any event to be the only conclusion which can logically be reached. Directors are the agents of the corporation. **3 Fletcher Cyclopedia of Corporations (Permanent Edition) Section 888.** Obviously the corporation, their principal, will be bound itself by such a statutory limitation upon their actions in a matter in which they alone can act as such agents, since it is only through its agents that the corporation can act at all.

vering v. Canfield, 291 U. S. 163, 166; Willcuts v. Milton Dairy Co., 275 U. S. 215, 218. See also *Edwards v. Douglas, 269 U. S. 204, 214.*

This is the uniform definition of it under statutes of the character above-quoted.

POINT VI.

IMPOSITION OF THE SURTAX ON INCOME WHICH IS NOT DISTRIBUTABLE VIOLATES BOTH THE TAXING STATUTE AND THE FIFTH AMENDMENT.

Under *Section 14 (b)* the surtax is measured only by the *undistributed* net income, which by the differentiation implicit in the use of the word "undistributed" inescapably implies the possibility of distribution. It is impossible to avod the conclusion that *the income in question, to be considered for surtax purposes at all, must be distributable;* otherwise the tax would not be an undistributed profits tax but merely an income tax. To say, therefore, that the tax shall be imposed on undistributed income which *could not be distributed* is thoroughly inconsistent with the theory of the tax itself, an illogical construction which should not be permitted.

That the 1936 income of the petitioner was not distributable income is easily demonstrated. The laws of North Dakota, as above mentioned under Point V, prohibit distribution of dividends except from surplus profits arising from the business. In the face of the continuing capital deficit in 1936, any distribution by the petitioner to its stockholders would necessarily have been an encroachment upon capital and consequently a distribution not of "surplus profits", but of capital. Such a distribution would not constitute taxable income in the hands of the

stockholders[8] and, therefore, the petitioner would be denied any dividends paid credit for such distribution, since *Section 27 (h) of the Revenue Act of 1936* prohibits a dividends paid credit for any part of a distribution which is not a taxable dividend in the hands of stockholders.

Consequently, it is evident that the earnings of this corporation in 1936 did not constitute net income in its hands distributable as income and that therefore the tax imposed by *Section 14* cannot, under any reasonable construction of the statute, apply thereto. The decision below, however, would arbitrarily bring this petitioner and other deficit corporations under this surtax which, by its terms, should not apply to them. In so doing, it offends against the *Fifth Amendment* by unreasonably classifying such corporations with others which are differently situated with respect to the one essential fact upon which the incidence of the surtax turns.

POINT VII.

THE DECISION BELOW DISCRIMINATES AGAINST THE PETITIONER IN FAVOR OF OTHERS SIMILARLY SITUATED, IN VIOLATION OF THE FIFTH AMENDMENT.

It is axiomatic that discrimination in legislation, including tax legislation, must be based upon some reasonable basis of classification if it is not to be condemned as arbitrary and confiscatory under the *Fifth Amendment*. We submit that there exists no reasonable difference between "deficit corporations", forbidden by charter and state law to pay dividends, and corporations having contracts restricting dividends, which would justify discrimination between the two classes with respect to liability for surtax on undistributed profits.

---

8. **Hadden v. Commissioner, 49 F. (2d) 709 (C. C. A. 2); Helvering v. Canfield, 291 U. S. 163, 166.**

It was clearly the intent of Congress in imposing the tax to penalize, or at least tax, the retention of corporate income. In the case of corporations which were unable so to distribute income, Congress attempted to provide legislative relief under *Section 26 (c) of the Revenue Act of 1936*. The beneficiaries of that relief provision were corporations which had contracts preventing the payment of dividends or contracts which tied up current income for the purpose of payment of or provision for previous indebtedness. The manifest purpose was to avoid the injustice which would result in the case of corporations which, by reason of definite, preexisting obligations, could not obtain the dividends paid credit under *Section 27*.

From the viewpoint of distribution of income by way of dividends, however, which the statute itself makes the controlling factor, there is absolutely no relevant observable difference between corporations subject to restrictive contracts and corporations which are subject to charter contract restrictions imposed by state law by reason of an existing impairment of their capital. Corporations of both types, in the absence of *Section 26 (c)*, would be faced with the identical factual problem of being unable legally to distribute income by way of dividends and yet being taxed for not distributing such income. To say that one class shall have the benefit of the relief accorded by *Section 26 (c)*, and that the other class shall not (although the only difference is the unsignificant fact that one restriction results from an ordinary contract and the other from a special contract embodied in the corporate charter and applicable state law), is a violation of the *Fifth Amendment* by arbitrary discrimination without any reasonable factual basis. It is also a disregard of the intent and spirit of the Statute.

It is our contention that the charter in the present case constitutes a contract within the plain meaning of *Section 26 (c)*. If, however, such is not the case, then the Revenue Act of 1936 is fatally defective in so far as the partial relief of *Section 26 (c)* results in unjustified and unconstitutional discrimination. Certainly, sufficient doubt is raised on constitutional grounds to bring the decision of the Court below within the rule which has many times been stated by this Court and is thus expressed by Mr. Justice Holmes in *United States v. Jim Fuey Moy, 241 U. S. 394, 401:*

> "A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score. *United States ex rel. Atty. Gen. v. Delaware & H. Co., 213 U. S. 366, 408, 53 L. Ed. 836, 849, 29 Sup. Ct. Rep. 527.*"

POINT VIII.

THE LEGISLATIVE HISTORY AND INTENT AND SPIRIT OF THE STATUTE SUPPORT PETITIONER.

The Board of Tax Appeals held that because the House Bill contained a provision which would have given all deficit corporations relief and it did not appear in the Bill as amended by the Finance Committee of the Senate, it necessarily followed Congress did not intend to grant relief to deficit corporations in states where they could not legally declare dividends. This does not follow. The legislative history does not show the reason the provision was stricken. *Non constat* it was stricken because the Senate did not desire to grant relief to deficit corporations in those states where they could legally declare dividends and thus were under no contractual obligations not to do so. It was said in debates in the Senate that 36 states imposed limitations on the declaration of divi-

dends by corporations with an impairment of capital stock. *(Con. Rec. Vol. 80, Part 8, p. 9058.)* There were 12 states in which deficit corporations might legally declare dividends. Moreover the laws of the 36 states which prohibited dividends in some form did not all prohibit dividends where the capital stock was impaired.[9]

The legislative history supports our contention that most of the Members of Congress who were lawyers understood the traditional concept of a corporate charter as a contract was embraced within the contract provision upon which we rely. For example, Senator Walsh, a member of the Finance Committee, made a speech against the Bill wherein he stated there was no relief afforded by the Senate Bill to corporations having an impairment of capital stock. *(Con. Rec. 80, Part 8, p. 9058.)* After this speech and after the Senate Bill had been rewritten in conference in the form in which it was enacted, Senator Walsh was apparently told that he was wrong and that his objection was untenable because in the Senate Minority Report on the Conference Bill, June 19, 1936 *(80 Cong. Rec. Part 10, p. 10164)* signed by Senators Walsh and George, the following appears:

> "The defenders of the bill in the form which it has now taken contend that by sundry exemptions and modifications the smallest corporations are spared the full force of the new tax as well as helped by the lowering of the rates on the normal income tax; that the banks and insurance companies are entirely excluded; and that in some instances corporations under

9. In a group of states, including California and Delaware, corporations might pay dividends so long as the net assets were not reduced below the stated value of the preferred stock, albeit such dividends impaired the common stock, provided they were paid out of net earnings for the year. An Iowa corporation might pay dividends so long as its assets exceeded its liabilities to others than its stockholders. **(House Hearings, pp. 846, 847.)** See **23 California Law Review, 229. Theory of Anglo American Dividend Law, 28 Col. L. R. 1046; 29 Col. L. R. 461; 30 Col. L. R. 380, 954.**

contract not to pay dividends, *and forbidden by law to do so,* are permitted without extra penalties to apply a percentage of their earnings to reserve."[10] (Italics ours.)

The purpose, intent and underlying spirit of the law was to prevent rich men avoiding taxes by accumulating large earnings in corporations which they controlled. (See President's Message in *House Report No. 2475, 74th Cong., 2nd Sess.)* See also examination of witness by Senator Black. *Senate Hearings, pages 265 to 268. Sanford v. Commissioner, 106 F. (2d) 882, 884.*

Stockholders of a corporation, the capital of which was impaired, would not be taxable on distribution made out of capital. *Hadden v. Commissioner, 49 F. (2d) 709 (C. C. A. 2).* Such stockholders upon return of their capital might even have a loss deductible from other income and which would serve to reduce their taxes. The purpose of the law was to force taxable dividends into the hands of stockholders. A return of capital cannot be made taxable income by law. Also, as pointed out on page 21 hereof, a distribution was required to be taxable to a shareholder before a corporation could take credit for it.

Congress certainly could not have intended to permit rich and prosperous corporations to avoid this special surtax and to take that privilege away from deficit corporations and penalize them for being unsuccessful.

---

10. It should be noted that this was a report on the final Bill which became law. The preceding bills passing the House and Senate were different from this. As said in the supplement to the **Law of Income Taxation, Paul & Mertens, par. 32A-05:** "The House and Senate 1936 Bills were dissimilar in general aim, theory and in structure. The 1936 Act, as finally enacted, was to a considerable extent written in conference without any new statement of legislative intent—a fact which contributes in no small measure to the difficulty of interpretation of the Act."

To impose a heavier tax on a corporation with impaired capital stock than on a rich corporation with a surplus would be to ruin the corporation in failing circumstances and promote the prosperous one. Yet, under the construction of the Court below that is what the law does. This construction is at variance with the underlying purpose, spirit and intent of the Act which the Court below wholly ignored and is untenable tested from any angle.

For the foregoing reasons the Writ of *Certiorari* should be granted.

All of which is respectfully submitted.

JOHN E. HUGHES,
First National Bank Bldg.,
Chicago, Illinois,
Counsel for Petitioner.